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ABSTRACT

This guide to creative home financing outlines basic concepts needed in shopping for a home loan. Many plans are described so that buyers can make their own decisions. The guide contains three sections: (1) getting started--highlighting the essentials; (2) defining terms; and (3) payment tables. The first section summarizes 15 financing plans in a reference chart: fixed rate mortgage; 15-year mortgage; adjustable rate mortgage; renegotiable rate mortgage (rollover); balloon mortgage; graduated payment mortgage; shared appreciation mortgage; assumable mortgage; seller take-back; wraparound; growing equity mortgage (rapid payoff mortgage); land contract; buy-down; rent with option; and reverse annuity mortgage (equity conversion). Type, description, and considerations are included for each plan. In addition to defining the 15 summarized plans, the second section discusses changing rates, reading the fine print, and losing ground. The third section includes some financial tables to estimate the monthly costs for principal and interest of a specific mortgage or loan. An index and Federal Trade Commission addresses and phone numbers are included. (NLA)

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THE MORTGAGE MONEY GUIDE

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Updated Edition from the Federal Trade Commission

Creative Financing For Home Buyers

CE 061 382

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About This Manual

This manual is a guide to creative home financing. It is intended to help you learn some of the basic concepts needed for shopping for a home loan. While our list of many plans does not fit on these pages, we have not attempted to explore every financing technique on the market. New financing alternatives are frequently being introduced, and this manual does not recommend any particular plan over the others. Shop and compare the options to decide which plan is best for you.

1. Getting Started

Home buying in the 1990s involves new rules. Learn about them before you get started. . . . 1

Highlighting the Essentials

More than a dozen financing plans are summarized in a chart which you can use for handy reference. . . . 2-3

2. Defining Your Terms

Descriptions of the plans will give you the shopping knowledge you need. Important background information appears in special boxes.

Fixed-Rate Mortgage . . . 4
Fifteen-Year Mortgage . . . 5
Adjustable Rate Mortgage . . . 6
- Rate Caps . . . 6
- Payment Caps . . . 7
- Variations . . . 7
- Summary . . . 8

Balloon Mortgage . . . 8
Graduated Payment Mortgage . . . 9
Growing Equity Mortgage . . . 10
Shared Appreciation Mortgage . . . 10
Changing Rates . . . 10
Assumable Mortgage . . . 11
Seller Take-Back . . . 11
Reading the Fine Print . . . 12
Wraparound Mortgage . . . 13
Land Contract . . . 13
Buy-down . . . 13
Rent with Option to Buy . . . 14
Reverse Annuity Mortgage . . . 14
Losing Ground . . . 15

3. Payment Tables

This manual does not cover all the costs associated with purchasing a home, such as closing costs. We have included some financial tables to help you estimate the monthly costs for principal and interest at specific mortgage rates.

Index

You'll find an index on the back of the booklet. Use it to locate places where key words and phrases are defined. . . . inside back cover

Addresses

If you need additional information, contact the Federal Trade Commission. . . . inside back cover

This manual was prepared by staff members of the Commission's Division of Credit Practices and the Office of Consumer and Business Education. It does not necessarily reflect the views of the Commission or any individual Commissioner. For further information, call (202) 326-3758.

GETTING STARTED

If you've been thinking about buying a home, you may wonder how to select the right financing for your budget and needs. Many types of mortgages are now available, and new plans are continually being introduced. With all these choices, you may wonder what to look for.

Some of the mortgages now available are traditional plans, with interest rates and payments that remain constant throughout the loan and pay off your debt over a long period. Others represent a departure from the older plans: they can involve more risk for the buyer and are frequently tied to changes in the market. But they also can make home buying possible and may offer lower interest rates.

So if you want to purchase a home, you can still find the right mortgage for your needs. But to make sure you understand the choices, you should educate yourself first.

This guide will introduce you to some of the many plans available. Other sources of information include your state, county, or city consumer affairs office; local realtors, home builders, and lenders; bookstores; and the real estate section of your newspaper. You may also want to buy a book of mortgage payment tables to help you calculate whether you can afford a specific loan.

Above all, shop carefully. And, as you read through this booklet, keep in mind the following:

- ☐ Don't use yesterday's assumptions about today's real estate market.
- ☐ The key is affordability. Consider your total housing costs —including loan payments (now and in the future), maintenance, property taxes, and your anticipated income changes.
- ☐ Look into several sources of financing. You may be able to combine two or more mortgages.
- ☐ Ask questions. For example, an enthusiastic seller may not be familiar with the fine points of the financing arrangement.
- ☐ Negotiate with the seller or lender. Better terms may be available than those initially offered.
- ☐ Consider getting an attorney or a real estate broker to represent you. This could be the largest investment of your life.
- ☐ Study all available materials about your mortgage costs. With loans from institutional lenders, the creditor is required to give you a statement of your loan costs and terms before you sign the agreement. This information will include the "annual percentage rate" (APR) which measures your total credit costs, including interest, points, and mortgage insurance.

Finally, if you're thinking about refinancing your current home mortgage, you may also find this guide helpful. When you refinance, you are actually signing a new mortgage and paying off your present one. So, you might save money by switching to a different type of mortgage. Ask several lenders what terms and types of mortgages are available, and bargain for the deal that best suits your needs.

HIGHLIGHTING THE ESSENTIALS*

Type	Description
Fixed Rate Mortgage	Fixed interest rate, usually long-term, equal monthly payments of principal and interest until debt is paid in full.
Fifteen-Year Mortgage	Fixed interest rate. Requires down payment or monthly payments higher than 30-year loan. Loan is fully repaid over 15-year term.
Adjustable Rate Mortgage	Interest rate changes over the life of the loan, resulting in possible changes in your monthly payments, loan term, and/or principal. Some plans have rate or payment caps.
Renegotiable Rate Mortgage (Rollover)	Interest rate and monthly payments are constant for several years; changes possible thereafter. Long-term mortgage.
Balloon Mortgage	Monthly payments based on fixed interest rate; usually short-term; payments may cover interest only, with principal due in full at term end.
Graduated Payment Mortgage	Lower monthly payments rise gradually (usually over 5–10 years), then level off for duration of term. With adjustable interest rate, additional payment changes possible if index changes.
Shared Appreciation Mortgage	Below-market interest rate and lower monthly payments, in exchange for a share of profits when property is sold or on a specified date. Many variations.
Assumable Mortgage	Buyer takes over seller's original, below-market rate mortgage.
Seller Take-back	Seller provides all or part of financing with a first or second mortgage.
Wraparound	Seller keeps original low rate mortgage. Buyer makes payments to seller who forwards a portion to the lender holding original mortgage. Offers lower effective interest rate on total transaction.
Growing Equity Mortgage (Rapid Payoff Mortgage)	Fixed interest rate but monthly payments may vary according to agreed-upon schedule or index.
Land Contract	Seller retains original mortgage. No transfer of title until loan is fully paid. Equal monthly payments based on below-market interest rate with unpaid principal due at loan end.
Buy-down	Developer (or other party) provides an interest subsidy which lowers monthly payments during the first few years of the loan. Can have fixed or adjustable interest rate.
Rent with Option	Renter pays "option fee" for right to purchase property at specified time and agreed-upon price. Rent may or may not be applied to sales price.
Reverse Annuity Mortgage (Equity Conversion)	Borrower owns mortgage-free property and needs income. Lender makes monthly payments to borrower, using property as collateral.

*Please see the section, "Defining Your Terms" on pages 4-15, for additional discussion of these concepts.

Considerations
Offers stability and long-term tax advantages. Interest rates may be higher than other types of financing. New fixed rates are rarely assumable.
Frequently offered at slightly reduced interest rate. Offers faster accumulation of equity than traditional fixed rate mortgage but has higher monthly payments. Involves paying less interest but this may result in fewer tax deductions.
Starting interest rate is slightly below market, but payments can increase sharply and frequently if index increases. Payment caps prevent wide fluctuations in payments but may cause negative amortization (see box, page 15). Rate caps limit amount total debt can expand.
Less frequent changes in interest rate offer some stability.
Offers low monthly payments but possibly no equity until loan is fully paid. When due, loan must be paid off or refinanced. Refinancing poses high risk if rates climb.
Easier to qualify for. Buyer's income must be able to keep pace with scheduled payment increases. With an adjustable rate, payment increases beyond the graduated payments can result in additional negative amortization (see box, page 15).
If home appreciates greatly, total cost of loan jumps. If home fails to appreciate, projected increase in value may still be due, requiring refinancing at possibly higher rates.
Lowers monthly payments. May be prohibited if "due on sale" clause is in original mortgage (see box, page 12). Not permitted on most new fixed rate mortgages.
May offer a below-market interest rate; may have a balloon payment requiring full payment in a few years or refinancing at market rates, which could sharply increase debt.
Lender may call in old mortgage and require higher rate. If buyer defaults, seller must take legal action to collect debt.
Permits rapid payoff of debt because payment increases reduce principal. Buyer's income must be able to keep up with payment increases.
May offer no equity until loan is fully paid. Buyer has few protections if conflict arises during loan.
Offers a break from higher payments during early years. Enables buyer with lower income to qualify. With adjustable rate mortgage, payments may jump substantially at end of subsidy. Developer may increase selling price.
Enables renter to buy time to obtain down payment and decide whether to purchase. Locks in price during inflationary times. Failure to take option means loss of option fee and rental payments.
Can provide homeowners with needed cash. At end of term, borrower must have money available to avoid selling property or refinancing.

DEFINING YOUR TERMS

To buy or sell a home today, it's important to know the vocabulary. Don't let terms like "amortization" or "appreciation" scare you. Understanding the concepts can save you time and money; it can also prevent you from obtaining a mortgage ill-suited to your needs.

Three important words are: "interest," "principal," and "equity." When you first buy a home you're likely to make a down payment on the property. But, because you financed the purchase, you are now in debt and the lender "owns" most of the property's value. In traditional mortgages, the monthly payments on the loan are weighted. During the first years, they are largely *interest;* in time, more of each payment is credited to the loan itself, or the *principal*. Gradually, as you pay off principal, you build up *equity*, or ownership. Your equity also increases if the value of the home increases. This process of gradually obtaining equity and reducing debt through payments of principal and interest is called *amortization*.

Until recently most mortgages had fixed monthly payments, a fixed interest rate, and full amortization (or transfer of equity) over a period of 20 to 30 years. These features worked in the buyer's favor. Inflation made your payments seem less and your property worth more. So, although the payments seemed hard to meet at first, over time, it became easier.

Many home financing plans are different from traditional mortgages. They may help you buy a home you otherwise couldn't, but they also may involve greater risks for buyers. For example, the interest rate and monthly payments may change during the loan to reflect what the market will bear. Or the interest rate may fluctuate while the payments stay the same, and the amount of principal paid off may vary. The latter approach allows the lender to credit a greater portion of the payment to interest when rates are high. Some plans also offer below-market interest rates, but they may not help you build up equity.

In shopping for financing sources today, keep in mind the terms which are keys to the affordability of the home:

- ☐ the *sales price minus your down payment*, or amount you finance;
- ☐ the length, or *maturity* of the loan;
- ☐ the size of the *monthly payments;*
- ☐ *the interest rate* or rates;
- ☐ whether the payments or rates may *change;*
- ☐ *how often* and how *much* the payments or rates may change; and,
- ☐ whether there is an *opportunity for refinancing* the loan when it matures, if necessary.

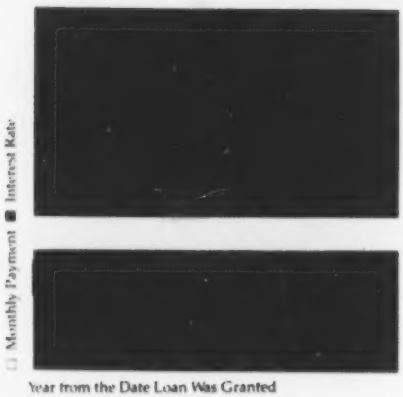
These concepts will be discussed in greater detail as we describe specific types of financing.

Fixed Rate Mortgage

Fixed rate mortgages have an interest rate and monthly payments that remain constant over the life of the loan. This sets a maximum on the total amount of principal and interest you pay during the loan. Traditionally, these mortgages have been long-term. As the loan is repaid, ownership shifts gradually from lender to buyer.

For example, suppose you borrow $50,000 at 13% for 30 years. Your monthly payments on this loan would be $553.10. Over 30 years, your total obligation for principal and interest would never exceed this fixed, predetermined amount.

Fixed rate mortgages are usually available at higher rates than many other types of loans. But, if you can afford the monthly payments, inflation and tax deductions may make a fixed rate mortgage a good financing method, particularly if you are in a high tax bracket and need the interest deductions.



Fixed Rate Mortgage
*Traditionally both interest rate and monthly payments are fixed for the life of the loan.**

Fifteen-Year Mortgage

The fifteen year mortgage is a variation of the fixed rate mortgage that is becoming increasingly popular. This mortgage has an interest rate and monthly payments that are constant throughout the loan. But, unlike other plans, this loan is fully paid off in only fifteen years. And, it is usually available at a slightly lower interest rate than a longer-term loan. But it also requires higher payments.

Suppose you buy a house for $100,000, and after making a $15,000 down payment, you still need to borrow $85,000. You find a 30-year mortgage for 12%. This means your monthly payments would be $874.32. But, another lender offers you a 15-year plan for a lower rate, 11.5%. However, under this plan, your payments would be $992.96, $119 higher than the longer-term financing.

In the fifteen-year mortgage, you pay off the loan balance faster than a long-term loan. Because of this, a smaller proportion of each of your monthly payments goes to interest. So, if you can afford the higher payments, this plan will save you interest and help you build equity and own your home faster. Because you are paying less interest, though, you may also have fewer tax deductions.

Adjustable Rate Mortgage

Adjustable rate mortgages have an interest rate that increases or decreases over the life of the loan based upon market conditions. Some lenders refer to adjustable rates as *flexible* or *variable*. Because adjustable rate loans can have different provisions, you should evaluate each one carefully.

In most adjustable rate loans, your starting rate, or "initial interest rate," will be lower than the rate offered on a standard fixed rate mortgage. This is because your long-term risk is higher — your rate can increase with the market — so the lender offers an inducement to take this plan.

Changes in the interest rate are usually governed by a financial index (see box, page 10). If the index rises, so may your interest rate. In some plans, if the index falls, so may your rate. Examples of these indexes are the Federal Home Loan Bank Board's national average mortgage rate and the U.S. Treasury bill rate. Generally, the more sensitive the index is to market changes, the more

Adjustable Rate Mortgage
If there are no payment or rate caps, interest rate and monthly payments fluctuate according to an index.

*The charts contained in this manual are for illustrative purposes only. They are not intended to be precise representations of each type of mortgage.

Adjustable Rate Mortgage-Rate Cap

With a rate cap, even if the index rises, increases in the rate and monthly payment are limited.

frequently your rate can increase or decrease.

Suppose your interest rate is tied to the Bank Board index. Your mortgage limits rate changes to one per year, although it doesn't limit the amount of the change. For example, assume your starting interest rate is 11% on September 1, 1986. Based on these terms, if the Bank Board index rises 2 percentage points by September 1, 1987, your new rate for the next year will be 13%.

Rate Caps

To build predictability into your adjustable rate loan, some lenders include provisions for "rate caps" that limit the amount your interest rate may change. These provisions limit the amount of your risk.

A *periodic rate cap* limits the amount the rate can increase at any one time. For example, your mortgage could provide that even if the index increases 2% in one year, your rate can only go up 1%. An *aggregate rate cap* limits the amount the rate can increase over the entire life of the loan. This means that, for example, even if the index increases 2% every year, your rate cannot increase more than 5% over the entire loan.

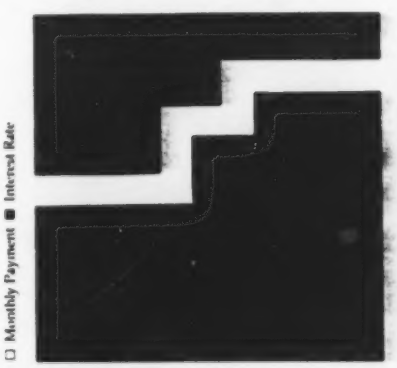
Many flexible rate mortgages offer the possibility of rates that may go down as well as up. In some loans, if the rate can only increase 5%, it may only decrease 5%. If no limit is placed on how high the rate can go, there may be a provision that also allows your rate to go down along with the index.

Because they limit the lender's return, capped rates may not be available through every lender.

Payment Caps

If the interest rate on your adjustable rate loan increases and your loan has a *payment cap*, your monthly payments may not rise, or they may increase by less than changes in the index would require.

For example, assume your mortgage provides for unlimited changes in your interest rate but your loan has a $50 per year cap on payment increases. You started with a 11% rate on your $75,000 mortgage and a monthly payment of $714.24. Now assume that your index increases 2 percentage points in the first year of your loan. Because of this, your rate increases to 13%, and your payments in the second year two should



Adjustable Rate Mortgage-Payment Cap

If the index increases, so does the interest rate. However, monthly payment changes are limited (although the total amount owed may increase).

rise to $828.33. Because of the payment cap, however, you'll only pay $764.24 per month in the second year.

But remember: if your payment-capped loan results in monthly payments that are lower than your interest rate would require, you still owe the difference. Negative amortization (see box page 15) may take place to ensure that the lender eventually receives the full amount. In most payment-capped mortgages, the amount of principal paid off changes when interest rates fluctuate. Suppose you are paying $650 a month with $500 going toward interest, with your rate at 12%. Then your rate increases to 13%. This means your monthly payment should increase to $697.39, but because of a cap, it increases to only $675. Because this change in interest rates increases your debt, the lender may now apply a larger portion of your payment to interest. If rates get very high, even the full amount of your monthly payment ($675) won't be enough to cover the interest owed; the additional amount of interest you owe will be added to the principal. This means you now owe — and eventually will pay — interest on interest.

Variations

One variation of the adjustable rate mortgage is to fix the interest rate for a period of time — 3 to 5 years, for example — with the understanding that the interest rate will then be *renegotiated*. Loans with periodically renegotiated rates are also called *rollover mortgages*. Such loans make monthly payments more predictable because the interest rate is fixed for a longer time.

Another variation is the *pledged account buy-down mortgage with an adjustable rate*. This plan was introduced by the Federal National Mortgage Association (Fannie Mae), which buys mortgages from lenders and provides a major source of money for future mortgage offerings.

In this plan, a large initial payment is made to the lender at the time the loan is made. The payment can be made by the buyer, the builder, or anyone else willing to subsidize the loan. The payment is placed in an account with the lender where it earns interest. This plan helps lower your interest rate for the first year.

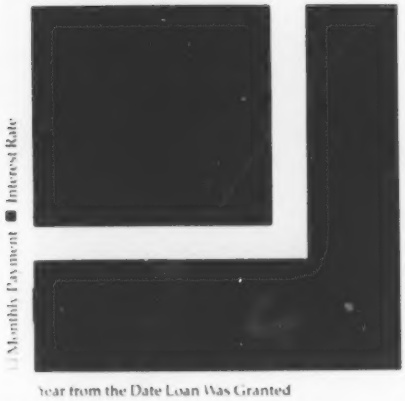
This plan could lower your rate, for example, by 4% in the first year. If you borrowed $50,000 at 13%, for example, this would reduce your rate to 9% and your monthly payments to $402.31, a savings of approximately $151 monthly. Then, for the next 5 years, your interest rate would only increase, for example, by 1 point each year. After that, your mortgage becomes an adjustable rate mortgage with interest rate and payment changes based upon an index.

This plan may not include any payment or rate caps other than those in the first years. But, there also may not be negative amortization, so possible increases in your total debt may be limited. Because of the buy-down feature, some buyers may be able to qualify for this loan who otherwise would not be eligible for financing.

Summary

In shopping for any type of adjustable rate loan, remember to look for the following:

- ☐ the initial interest rate;
- ☐ how often the rate may change;
- ☐ how much the rate may change;
- ☐ the initial monthly payments;
- ☐ how often payments may change;
- ☐ how much the payments may change;
- ☐ the mortgage term;
- ☐ how often the term may change;
- ☐ how much the term may change;
- ☐ the index that rate, payment, or term changes are tied to; and,
- ☐ the limits, if any, on negative amortization.



Balloon Mortgage

Fixed interest rate; payments are also fixed but may apply only to interest. After short term, a final payment of principal is due.

Balloon Mortgage

Balloon mortgages have a series of equal monthly payments and a large final payment. Although there usually is a fixed interest rate, the equal payments may be for interest only. The unpaid balance, frequently the principal or the original amount you borrowed, comes due in a short period, usually 3 to 5 years.

For example, suppose you borrow $30,000 for 5 years. The interest rate is 13%, and the monthly payments are only $325. But in this example, the payments cover interest only, and the entire principal is due at maturity — in 5 years. That means you'll have to make 59 equal monthly payments of $325 each and a final balloon payment of $30,325. If you can't make that final payment, you'll have to refinance (if refinancing is available) or sell the property.

Some lenders guarantee refinancing when the balloon payment is due, although they do not guarantee a certain interest rate. The rate could be higher than your current rate. Other lenders do not offer automatic refinancing. Without such a guarantee, you could be forced to start the whole business of shopping for housing money once again, as well as paying closing costs and front-end charges a second time.

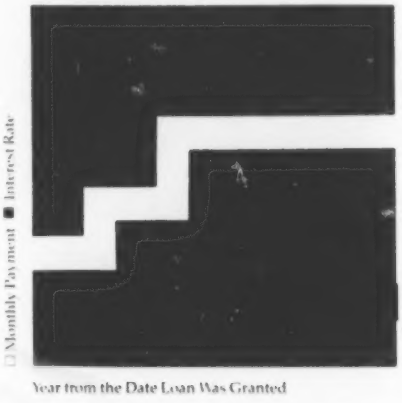
A balloon note may also be offered by a private seller who is continuing to carry the mortgage he or she took out when purchasing the home. It can be used as a second mortgage where you also assume the seller's first mortgage.

Graduated Payment Mortgage

Graduated payment mortgages (GPM) are designed for home buyers who expect to be able to make larger monthly payments in the near future. During the early years of the loan, payments are relatively low. They are structured to rise at a set rate over a set period, say 5 or 10 years. Then they remain constant for the duration of the loan.

Even though the payments change, the interest rate is usually fixed. So during the early years, your payments are lower than the amount dictated by the interest rate. During the later years, the difference is made up by higher payments. At the end of the loan, you will have paid off your entire debt.

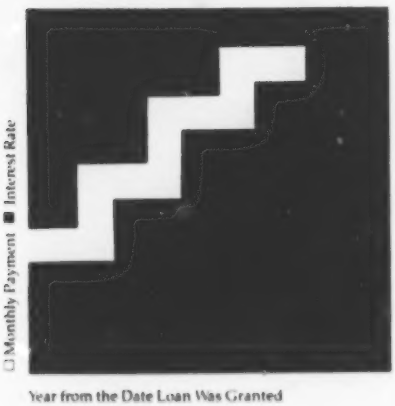
One variation of the GPM is the



Graduated Payment Mortgage

Fixed interest rate; payments rise gradually for first few years, then level off for duration of loan.

graduated payment, adjustable rate mortgage. This loan also has graduated payments early in the loan. But, like other adjustable rate loans, it ties your interest rate to changes in an agreed-upon index. If interest rates climb quickly, greater negative amortization occurs during the period when payments are low. If rates continue to climb after that initial period, the payments will, too. This variation adds increased risk for the buyer. But if interest rates decline during the life of the loan, your payments may as well.



Growing Equity Mortgage
Fixed interest rate, but payments may rise according to agreed-upon schedule or an index. Increases are applied to principal, shortening term of loan.

Growing Equity Mortgage
(Rapid Payoff Mortgage)

The growing equity mortgage (GEM) and the rapid payoff mortgage are among the other plans on the market. These mortgages combine a fixed interest rate with a changing monthly payment. The interest rate is usually a few percentage points below market. Although the mortgage term may run for 30 years, the loan will frequently be paid off in less than 15 years because payment increases are applied entirely to the principal.

Monthly payment changes are based on an agreed-upon schedule of increases or an index. For example, the plan might use the U.S. Commerce Department index that measures after-tax, per capita income, and your payments might increase at a specified portion of the change in this index, say 75%.

Suppose you're paying $500 per month. In this example, if the index increases by 8%, you will have to pay 75% of that, or 6%, additional. Your payments will increase to $530, and the additional $30 you pay will be used to reduce your principal.

With this approach, your income must be able to keep pace with the increased payments. The plan does not offer long-term tax deductions. However, it can permit you to pay off your loan and acquire equity rapidly.

Shared Appreciation Mortgage

In the shared appreciation mortgage (SAM), you make monthly payments at a relatively low interest rate. You also agree to share with the lender a sizable percent (usually 30% to 50%) of the appreciation in your home's value when you sell or transfer the home, or after a specified number of years.

Because of the shared appreciation feature, monthly payments in this plan are lower than in many other plans. However, you may be liable for the dollar amount of the property's appreciation even if you do not wish to sell the property at the agreed-upon date. Unless you have the cash available, this could force an early sale of the property. Also, if property values do not increase as anticipated, you may still be liable for an additional amount of interest.

There are many variations of this idea, called *shared equity* plans. Some are offered by lending institutions and others by individuals. For exam-

ple, suppose you've found a home for $100,000 in a neighborhood where property values are rising. The local savings and loan is charging 12% on home mortgages; assuming you paid $20,000 down and chose a 30-year term, your monthly payments would be $822.89, or about twice what you can afford. But a friend offers to help. Your friend will pay half of each monthly payment, or $420, for 5 years. At the end of that time, you both assume the house will be worth at least $125,000. You can sell it, and your friend can recover his or her share of the monthly payments to date plus half of the appreciation, or $12,500, for a total of $37,700. Or, you can pay your friend that same sum of money and gain increased equity in the house.

Another variation may give your partner tax advantages during the first years of the mortgage, after which the partnership is dissolved. (You can buy out your partner or find a new one.) Your partner helps make the purchase possible by putting up a sizable down payment and

CHANGING RATES

Lenders use indexes to decide when to raise or lower the interest rate on an adjustable rate mortgage. For example, when the financial index your lender uses rises, the interest rate on your mortgage may also increase — it depends on how the index is applied. Fluctuations in the interest rate can change your monthly payments, mortgage length, or principal balance.

Some of today's most frequently used indexes are:

- ☐ *the rate on 6-month Treasury bills*, or on *3-year Treasury notes* (or how much the U.S. Treasury is willing to pay on money it borrows);
- ☐ *the Federal Home Loan Bank Board's national average mortgage contract rate* charged by major lenders on the purchase of previously occupied homes (or how much people are paying on new mortgages nationwide); and,
- ☐ *the average costs of funds* for savings and loans insured by the Federal Savings and Loan Insurance Corporation (or how much lending institutions are paying on the money they borrow).

Some indexes reflect what the market will bear across the country; others reflect local trends. Also, some money indexes are controlled solely by individual lenders. The index you select should be one that can be verified easily; its past performance may give you an indication of how stable it is. Have someone with expertise translate past and potential changes into dollars and cents.

Also find out how the index is used. For example, if the index changes monthly, is the lender also changing the rate on your loan monthly? Or, are there limits on the number of times and/or the amount your rate can fluctuate?

Finally, check how much advance warning the lender will give you before your new rate and/or new payments go into effect.

or helping make the monthly payments. In return, your partner may be able to deduct a certain amount from his or her taxable income. Before proceeding with this type of plan, check with the Internal Revenue Service to determine the exact requirements.

Shared appreciation and shared equity mortgages were partly inspired by rising interest rates and partly by the notion that housing values would continue to grow over the years to come. If property values fall, these plans may not be available.

Assumable Mortgage

An assumable mortgage is a mortgage that can be passed on to a new owner at the previous owner's interest rate. For example, suppose you're interested in a $75,000 home. You make a down payment of $25,000, and you still owe $50,000. The owner of the home has paid off $20,000 of a $30,000, 10% mortgage. You assume the present owner's mortgage, which has $10,000 outstanding. You also make additional financing arrangements for the remaining $40,000, for example, by borrowing that amount from a mortgage company at the current market rate of 12%. Your overall interest rate is lower than the market rate because part of the money you owe is being repaid at 10%.

During periods of high rates, most lending institutions are reluctant to permit assumptions, preferring to write a new mortgage at the market rate. Some buyers and sellers are still using assumable mortgages, however. This has recently resulted in many lenders calling in the loans under "due on sale" clauses (see box, page 12). Because these clauses have increasingly been upheld in court, many mortgages are no longer legally assumable. Be especially careful, therefore, if you are considering a mortgage represented as "assumable." Read the contract carefully and consider having an attorney or other expert check to determine if the lender has the right to raise your rate in this mortgage.

Seller Take-back

This mortgage, provided by the seller, is frequently a "second trust" and is combined with an assumed mortgage. The second trust (or "second mortgage") provides financing in addition to the first assumed mortgage, using the same property as collateral. (In the event of default, the second mortgage is satisfied after the first). Seller take-backs frequently involve payments for interest only, with the principal due at maturity.

For example, suppose you want to buy a $150,000 home. The seller owes $70,000 on a 8% mortgage. You assume this mortgage and make a $30,000 down payment. You still need $50,000. So the seller gives you a second mortgage, or take-back, for $50,000 for 5 years at 10% (well below the market rate) with payments of $416.67. However, your payments are for interest only, and in 5 years you will have to pay $50,000. The seller take-back, in other words, may have enabled you to buy the home. But it may also have left you with a sizable balloon payment that must be paid off in the near future.

Some private sellers are also offering first trusts as take-backs. In this approach, the seller finances the major portion of the loan and takes back a mortgage on the property.

Another development now enables private sellers to provide this type of financing more frequently. Previously, sellers offering take-backs were required to carry the loan to full term before obtaining their equity. However, now, if an institutional lender arranges the loan, uses standardized forms, and meets certain other requirements, the owner

take-back can be sold immediately to Fannie Mae. This approach enables the seller to obtain equity promptly and avoid having to collect monthly payments.

READING THE FINE PRINT

Before going ahead with a creative home loan, you may want to have a lawyer or other expert help you interpret the fine print. You may also want to consider some of the situations you could face when paying off your loan or selling your property. Also, make sure you understand the terms in your agreement—such as *acceleration, due on sale* clauses, and *waivers.*

An *acceleration clause* allows the lender to speed up the rate at which your loan comes due. Suppose you've missed a payment, and your contract gives the lender the right to "accelerate" the loan when a payment is missed. This means that the lender now has the power to force you to repay the entire loan immediately.

Here, taken from a mortgage contract, is a sample acceleration clause: *"In the event any installment of this note is not paid when due, time being of the essence, and such installment remains unpaid for thirty (30) days, the Holder of this Note may, at its option, without notice or demand, declare the entire principal sum then unpaid, together with secured interest and late charges thereon, immediately due and payable. The lender may without further notice or demand invoke the power of sale and any other remedies permitted by applicable law."*

Note the use of the term "without notice" above. If this contract provision is legal in your state, you have *waived* your right to notice. In other words, you've given up the right to be notified of some occurrence—for example, a missed payment. If you've waived your right to notice of delinquency or default, and you've made a late payment, action may be initiated against you before you've been told; the lender may even start to foreclose.

Know whether your contract waives your right to notice. If so, obtain a clear understanding in advance of what you're giving up. And consider having your attorney check state law to determine if the waiver is legal.

A *due on sale* clause gives the lender the right to require immediate repayment of the balance you owe if the property changes hands. Here's an example of a due on sale clause: *"If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent . . . Lender may, at Lender's option, declare all the sums secured by this Mortgage to be immediately due and payable."*

Due on sale clauses have been included in many mortgage contracts for years. They are being enforced by lenders increasingly when buyers try to assume sellers' existing low rate mortgages. In these cases, the courts have frequently upheld the lender's right to raise the interest rate to the prevailing market level. So be especially careful when considering an "assumable mortgage." If your agreement has a due on sale provision, the assumption may not be legal, and you could be liable for thousands of additional dollars.

Wraparound

Another variation on the second mortgage is the wraparound. Suppose you'd like to buy a $75,000 condominium and can make a $25,000 down payment, but can't afford the payments at the current rate (12%) on the remaining $50,000. The present owners have a $30,000, 8% mortgage. They offer you a $50,000 wraparound mortgage at 10%. The new loan *wraps around* the existing $30,000 mortgage, adding $20,000 to it. You make all your payments to the second lender or the seller, who then forwards payments for the first mortgage. You'll pay the equivalent of 8% on the $30,000 to the first lender, plus an additional 2% on this amount to the second lender, plus 10% on the remaining $20,000. Your total loan costs using this approach will be lower than if you obtained a loan for the full amount at the current rate (for example, 12%).

Wraparounds may cause problems if the original lender or the holder of the original mortgage is not aware of the new mortgage. Upon discovering this arrangment, some lenders or holders may have the right to insist that the old mortgage be paid off immediately.

Land Contract

Borrowed from commercial real estate, this plan enables you to pay below-market interest rates. The installment land contract permits the seller to hold onto his or her original below-market rate mortgage while "selling" the home on an installment basis. The installment payments are for a short term and may be for interest only. At the end of the contract the unpaid balance, frequently the full purchase price, must still be paid.

The seller continues to hold title to the property until all payments are made. Thus, you, the buyer, acquire no equity until the contract ends. If you fail to make a payment on time, you could lose a major investment.

Fixed Rate Mortgage with Buy-down
Rate and payments are relatively low for first few years, then jump to reflect full rate in mortgage.

These loans are popular because they offer lower payments than market rate loans. Land contracts are also being used to avoid the due on sale clause (see box, page 12). The buyer and seller may assert to the lender who provided the original mortgage that the due on sale clause does not apply because the property will not be sold until the end of the contract. Therefore, the low interest rate continues. However, the lender may assert that the contract in fact represents a sale of the property. Consequently, the lender may have the right to accelerate the loan (see box, page 12), or call it due, and raise the interest rate to current market levels.

Buy-down

A buy-down is a subsidy of the mortgage interest rate that helps you meet the payments during the first few years of the loan. Suppose a new house sells for $150,000. After a down payment of $75,000, you still need to finance $75,000. A 30-year first mortgage is available for 12%, which would make your monthly payments $771.46, or beyond your

Adjustable Rate Mortgage with Buy-down

Rate and payments are initially low, then jump and may change throughout loan depending on changes in the index.

budget. However, a buy-down is available: for the first three years, the developer will subsidize your payments, bringing down the interest rate to 9%. This means your payments are only $603.47, which you can afford.

There are several things to think about in buy-downs. First, consider what your payments will be after the first few years. If this is a fixed rate loan, the payments in the above example will jump to the rate at which the loan was originally made — 12% — and total more than $770. If this is an adjustable rate loan, and the index to which your rate is tied has risen since you took out the loan, your payments could go up even higher.

Second, check to see whether the subsidy is part of your contract with the lender or with the builder. If it's provided separately by the builder, the lender can still hold you liable for the full interest rate (12% in the above example), even if the builder backs out of the deal or goes out of business.

Finally, that $150,000 sales price may have been increased to cover the builder's interest subsidy. A comparable home may be selling around the corner for less. At the same time, competition may have encouraged the builder to offer you a genuine savings. It pays to check around.

There are also plans called consumer buy-downs. In these loans, the buyer makes a sizable down payment, and the interest rate granted is below market. In other words, in exchange for a large payment at the beginning of the loan, you may qualify for a lower rate on the amount borrowed. Frequently, this type of mortgage has a shorter term than those written at current market rates.

Rent With Option to Buy

In a climate of changing interest rates, some buyers and sellers are attracted to a rent-with-option arrangement. In this plan, you rent property and pay a premium for the right to purchase the property within a limited time period at a specific price. In some arrangements, you may apply part of the rental payments to the purchase price.

This approach enables you to lock in the purchase price. You can also use this method to "buy time" in the hope that interest rates will decrease. From the seller's perspective, this plan may provide the buyer time to obtain sufficient cash or acceptable financing to proceed with a purchase that may not be possible otherwise.

Reverse Annuity Mortgage

If you already own your home and need to obtain cash, you might consider the reverse annuity mortgage (RAM) or "equity conversion." In this plan, you obtain a loan in the form of monthly payments over an extended period of time, using your property as collateral. When the loan comes due, you repay both the principal and interest.

A RAM is not a mortgage in the

conventional sense. You can't obtain a RAM until you have paid off your original mortgage. Suppose you own your home and you need a source of money. You could draw up a contract with a lender that enables you to borrow a given amount each month until you've reached a maximum of, for example, $10,000. At the end of the term, you must repay the loan. But remember, if you do not have the cash available to repay the loan plus interest, you will have to sell the property or take out a new loan.

LOSING GROUND

Repaying debt gradually through payments of principal and interest is called amortization. Today's economic climate has given rise to a reverse process called negative amortization.

Negative amortization means that you are losing — not gaining — value, or equity. This is because your monthly payments may be too low to cover the interest rate agreed upon in the mortgage contract. Instead of paying the full interest costs now, you'll pay them later — either in larger payments or in more payments. You will also be paying interest on that interest.

In other words, the lender postpones collection of the money you owe by increasing the size of your debt. In extreme cases, you may even lose the equity you purchased with your down payment, leaving you in worse financial shape a few years after you purchase your home than when you bought it.

Suppose you signed an adjustable rate mortgage for $50,000 in 1978. The index established your initial rate at 9.15%. It nearly doubled to 17.39% by 1981. If your monthly payments had kept pace with the index, they would have risen from $408 to $722. But because of a payment cap (see page 6), they stayed at $408. By 1981 your mortgage had swelled from $50,000 to $58,350, even though you had dutifully paid $408 every month for 48 months. In other words, you paid out $20,000 but you were $8,000 more in debt than you were three years earlier. During the next few years, despite the fact that the index fell gradually, you were still paying off the increases made to your principal from earlier years.

Certain loans, such as graduated payment mortgages, are structured so that you regain the lost ground with payments that eventually rise high enough to fully pay off your debt. And you may also be able to pay off the extra costs if your home is gaining rapidly in value or if your income is rising fast enough to meet the increased obligation. But if it isn't, you may realize a loss if, for example, you sign a below-market adjustable rate mortgage in January and try to sell the home in August when interest rates are higher. You could end up owing more than you'd make on the sale.

PAYMENT TABLES

8% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	506.91	303.32	238.91	209.11	192.95	183.44
30.000	608.29	363.98	286.70	250.93	231.54	220.13
35.000	709.67	424.65	334.48	292.75	270.14	256.82
40.000	811.06	485.31	382.26	334.58	308.73	293.51
45.000	912.44	545.97	430.04	376.40	347.32	330.19
50.000	1013.82	606.64	477.83	418.22	385.91	366.88
60.000	1216.58	727.97	573.39	501.86	463.09	440.26
70.000	1419.35	849.29	668.96	585.51	540.27	513.64
80.000	1622.11	970.62	764.52	669.15	617.45	587.01
90.000	1824.88	1091.95	860.09	752.80	694.63	660.39
100.000	2027.64	1213.28	955.65	836.44	771.82	733.76

9% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	518.96	316.69	253.57	224.93	209.80	201.16
30.000	622.75	380.03	304.28	269.92	251.76	241.39
35.000	726.54	443.36	354.99	314.90	293.72	281.62
40.000	830.33	506.70	405.71	359.89	335.68	321.85
45.000	934.13	570.04	456.42	404.88	377.64	362.08
50.000	1037.92	633.38	507.13	449.86	419.60	402.31
60.000	1245.50	760.05	608.56	539.84	503.52	482.77
70.000	1453.08	886.73	709.99	629.81	587.44	563.24
80.000	1660.67	1013.41	811.41	719.78	671.36	643.70
90.000	1868.25	1140.08	912.84	809.75	755.28	724.16
100.000	2075.84	1266.76	1014.27	899.73	839.20	804.62

10% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	531.18	330.38	268.65	241.26	227.18	219.39
30.000	637.41	396.45	322.38	289.51	272.61	263.27
35.000	743.65	462.53	376.11	337.76	318.05	307.15
40.000	849.88	528.60	429.84	386.01	363.48	351.03
45.000	956.12	594.68	483.57	434.26	408.92	394.91
50.000	1062.35	660.75	537.30	482.51	454.35	438.79
60.000	1274.82	792.90	644.76	579.01	545.22	526.54
70.000	1487.29	925.06	752.22	675.52	636.09	614.30
80.000	1699.76	1057.20	859.68	772.02	726.96	702.06
90.000	1912.23	1189.36	967.14	868.52	817.83	789.81
100.000	2124.70	1321.51	1074.61	965.02	908.70	877.57

11% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	543.56	344.38	284.15	258.05	245.03	238.08
30.000	652.27	413.25	340.98	309.66	294.03	285.70
35.000	760.98	482.13	397.81	361.27	343.04	333.31
40.000	869.70	551.00	454.64	412.88	392.05	380.93
45.000	978.41	619.88	511.47	464.48	441.05	428.55
50.000	1087.12	688.75	568.30	516.09	490.06	476.16
60.000	1304.54	826.50	681.96	619.31	588.07	571.39
70.000	1521.97	964.25	795.62	722.53	686.08	666.63
80.000	1739.39	1102.00	909.28	825.75	784.09	761.86
90.000	1956.81	1239.75	1022.94	928.97	882.10	857.09
100.000	2174.24	1377.50	1136.60	1032.19	980.11	952.32

*For loans that fully pay off the debt over the loan term.

12% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	556.11	358.68	300.05	275.28	263.31	257.16
30.000	667.33	430.42	360.06	330.33	315.97	308.59
35.000	778.56	502.15	420.06	385.39	368.63	360.02
40.000	889.78	573.89	480.07	440.44	421.29	411.45
45.000	1001.00	645.62	540.08	495.49	473.96	462.88
50.000	1112.22	717.36	600.09	550.55	526.62	514.31
60.000	1334.67	860.83	720.11	660.66	631.93	617.17
70.000	1557.11	1004.30	840.12	770.77	737.26	720.03
80.000	1779.56	1147.77	960.14	880.87	842.58	822.90
90.000	2002.00	1291.24	1080.15	990.98	947.90	925.75
100.000	2224.44	1434.71	1200.17	1101.09	1053.23	1028.62

13% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	568.83	373.28	316.32	292.90	281.96	276.55
30.000	682.60	447.94	379.58	351.48	338.36	331.86
35.000	796.36	522.59	442.84	410.06	394.75	387.17
40.000	910.13	597.25	506.10	468.64	451.14	442.48
45.000	1023.89	671.90	569.36	527.21	507.53	497.79
50.000	1137.66	746.56	632.63	585.79	563.92	553.10
60.000	1365.19	895.87	759.15	702.95	676.71	663.72
70.000	1592.72	1045.18	885.67	820.11	789.49	774.34
80.000	1820.25	1194.49	1012.20	937.27	902.27	884.96
90.000	2047.78	1343.80	1138.72	1054.42	1015.05	995.58
100.000	2275.31	1493.11	1265.25	1171.58	1127.84	1106.20

14% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	581.71	388.17	332.94	310.89	300.95	296.22
30.000	698.05	465.80	399.53	373.06	361.13	355.47
35.000	814.39	543.44	466.11	435.24	421.32	414.71
40.000	930.74	621.07	532.70	497.41	481.51	473.95
45.000	1047.08	698.70	599.29	559.59	541.70	533.20
50.000	1163.42	776.34	665.88	621.77	601.89	592.44
60.000	1396.10	931.60	799.05	746.12	722.26	710.93
70.000	1628.78	1086.87	932.22	870.47	842.64	829.42
80.000	1861.47	1242.14	1065.40	994.82	963.01	947.90
90.000	2094.14	1397.40	1198.57	1119.17	1083.38	1066.38
100.000	2326.83	1552.67	1331.75	1243.53	1203.77	1184.88

15% Annual Percentage Rate

Amount Financed	Monthly Payments (Principal and Interest)* 5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
$ 25.000	594.75	403.34	349.90	329.20	320.21	316.12
30.000	713.70	484.01	419.88	395.04	384.25	379.34
35.000	832.65	564.68	489.86	460.88	448.30	442.56
40.000	951.60	645.34	559.84	526.72	512.34	505.78
45.000	1070.55	726.01	629.82	592.56	576.38	569.00
50.000	1189.50	806.68	699.80	658.40	640.42	632.23
60.000	1427.40	968.01	839.76	790.08	768.50	758.67
70.000	1665.30	1129.35	979.72	921.76	896.59	885.12
80.000	1903.20	1290.68	1119.67	1053.44	1024.67	1011.56
90.000	2141.09	1452.01	1259.63	1185.11	1152.75	1138.00
100.000	2379.00	1613.35	1399.59	1316.79	1280.84	1264.45

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INDEX

Acceleration 12, 13
Adjustable Rate Mortgage 2, 5, 6, 7, 9, 10, 14, 15
Affordability 4
Aggregate Cap 6
Amortization 4
Annual Percentage Rate (APR) 1
Assumable Mortgage 2, 11, 12
Balloon Mortgage 2, 8, 11
Buy-down 2, 7, 13, 14
Due-on-Sale 11, 12, 13
Equity 4
Equity Conversion 2, 11, 15
Fannie Mae 7, 12
Federal Home Loan Bank Board 3, 10
Fifteen-Year Mortgage 2, 5
Fixed Rate Mortgage 2, 4, 5, 13
Flexible Rate Mortgage 5
FSLIC 10
Graduated Payment Mortgage 2, 8, 9
Growing Equity Mortgage 2, 9
Indexes 5, 10
Internal Revenue Service 11
Interest 4
Land Contract 2, 13
Negative Amortization 7, 15
Option to Buy 14
Payment Caps 6, 7
Payment Tables 16
Periodic Cap 6
Pledged Account Buy-down 7
Principal 4
Rapid Payoff Mortgage 2, 9
Rate Caps 6
Refinancing 1, 8
Renegotiable Rate Mortgage 2, 7
Rent with Option 2, 14
Reverse Annuity Mortgage 2, 14, 15
Right to Notice 12
Rollover Mortgage 2, 7
Second Mortgage 11
Second Trust 11
Seller Take-Back 2, 11, 12
Shared Appreciation Mortgage 2, 9, 10, 11
Shared Equity 9, 10, 11
U.S. Commerce Department 9
U.S. Treasury Bills 5, 10
Variable Rate Mortgage 5
Waiver 12
Wraparound Mortgage 2, 11, 13

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